UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

TESTIMONY OF ROGER C. VIADERO
INSPECTOR GENERAL
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U.S. DEPARTMENT OF AGRICULTURE

Before the

U.S. SENATE
COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY

on

FEDERAL CROP
INSURANCE REPORT

APRIL 21, l999

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MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I appreciate the opportunity to be here today to testify about the purpose and objectives of our recently issued Report to the Secretary On Federal Crop Insurance Reform. I would like to submit a copy of that report for the record. With me today is James R. Ebbitt, Assistant Inspector General for Audit.

Over the past several years, my office has issued many reports on various aspects of the Federal crop insurance program. Many of the issues raised in those reports have been addressed by RMA, but some critical ones have not. With the current economic crisis faced by our farmers, especially the small farmers, and congress' well-founded goal of ensuring an adequate safety net for those farmers, we thought it important to gather together what we consider to be the most significant issues from our prior reports, and to look back on how the billions of dollars already invested in this program have been used. We believe these issues merit discussion, with the end goal being a crop insurance program which protects the farmer <u>and</u> ensures a fair shake for the taxpayers.

We are pleased that our report has generated discussion. Some resulting comments misrepresented what our report says, but others indicate a need to redefine two items in our report--our discussion of program costs, and total reimbursement to the reinsured companies under the Catastrophic Risk Protection (CAT) Program. To that end, Mr. Chairman, the comments that committee staff provided to us were very helpful. We have therefore issued four revised pages which I have provided to you. None of these revisions affect in any way the report's conclusions or our suggestions for corrective action.

Perhaps our biggest incentive to prepare this report came from some farmers themselves who told us of their frustrations with being ill served by this program. For example, during our review of nursery crop policies, nursery growers asked to meet with us to see if we could do something to clean up abuses they were observing in the program. They advised that their complaints to the insurance industry and the government had not been addressed. They were incensed with some insurance agents who abused the program by fostering dishonest producers' ability to file false claims and incompetent insurance adjusters who adjusted those claims. These honest producers knew that these unchecked abuses were hurting them in two ways: first, the false claims would cause their own premiums to become unaffordable, and second, the government, through the insurance agents, provided cash windfalls to the dishonest producers, putting the many honest producers at a competitive disadvantage.

I would now like to provide you an overview of the issues contained in our report.

<u>Company Revenue Increased At The Expense Of Good Program Management</u>

We have been sharply criticized for describing reinsured companies' risk as minimal. Let me show you our basis for this description. Chart 1 now before you shows the total cost to the government, reinsured companies' gains and losses, and loss ratios for the 18 years since 1981, when legislation was passed which enabled for the first time private insurance companies to sell and service Federally-backed crop insurance policies. During these years, while the government spent over $14 billion on the program, the reinsured companies received a total of $1.35 billion in underwriting gains for 14 years and incurred less than $94 million in underwriting losses for 4 years. One of these 4 years, 1993, was the catastrophic midwestern floods. During that year, the government incurred costs of almost $1.4 billion. At the same time, the reinsured companies incurred an $82 million underwriting loss but also received $243 million in administrative expense reimbursements. Most significantly, in just the past four years, the reinsured companies' underwriting gains were almost $1.1 billion. From another perspective, the reinsured companies received almost 7 times as much in underwriting gains in the last 4 years than they received in the prior 14 years. At the same time, the government paid $5.4 billion for program costs, which consisted of total indemnities paid, plus compensation to the reinsured companies, plus RMA's administrative costs, less farmer-paid premiums. Also, just this past year the Government enacted about $6 billion in supplemental funding to pay producers for yield and price losses. This is our basis for using the term "minimal" to describe the reinsureds' share of risk in the program thus far.

This is also why we think it is prudent to recognize the total dollars going into the program, how those dollars have been used, and initiate a rational discussion to decide the most effective and efficient way for delivering various aspects of the crop insurance program. The National Association of State Departments of Agriculture has also recognized the need for such debates. They have issued a policy statement calling for the Farm Service Agency to be the primary deliverer of CAT policies, along with other recommendations for significant changes in program operations.

<u>Reinsureds' Substantial CAT Underwriting Gains VS. Less Program Participation</u>

The CAT Program was intended to provide the basic safety net to farmers and producers. The Secretary demanded an understanding and promise from the reinsured companies that they would properly service the limited resource farmers (farmers with gross incomes of less than $20,000) if he agreed to turn over the servicing of the CAT Program to them. However, the companies didn't keep this promise because they did not provide any special servicing to meet the needs of these farmers. Over the period 1995 through 1998, the number of CAT policies decreased by 66 percent. More significantly, the number of limited resource farmers in the CAT Program who had coverage in the past, slipped away from the program. Sadly, their participation in the CAT Program fell by 78 percent from 1997 to 1998. These are the farmers who frequently are least able to sustain losses and continue farming. We recently audited CAT servicing activities and found that reinsured companies did not instruct their agents to contact transferred limited resource producers to explain that they were eligible for administrative fee waivers and would not be charged for the CAT coverage.

From 1997 to 1998, the CAT Program was progressively turned over to the reinsured companies. In calculating the reinsured companies' underwriting gains and losses, RMA is authorized by statute to credit the companies for premiums which are based upon the amount of premium the insured would have paid if he/she had purchased comparable CAT coverage. Chart 2 shows the cost of the CAT Program to the Government, the indemnities paid to farmers and producers, and the underwriting gains enjoyed by the reinsured companies as a result of their being given the CAT Program to service. The reinsured companies received CAT underwriting gains of $305 million as a result of these calculations. Also, they received an additional $205 million in administrative expense reimbursements. At the same time farmers received $268 million in CAT indemnities. The Government paid reinsured companies about $2 for every $1 it paid to farmers from 1995 through 1998. Conversely, for "buy up" policies, reinsured companies received about $1.09 for every $1 paid to farmers.

Mr. Chairman, in addition to the costs of the Program which I have just discussed, the following are several operational issues we have reported which your committee needs to consider.

Conflicts Of Interest

While the Standard Reinsurance Agreement (SRA) prohibits conflict of interest, we found several situations which undermined the integrity of the claims adjustment process. For example, we found sales and claims supervisors supervised both sales agents and loss adjusters. These supervisors had direct control over the loss adjustments for policies that their agents sold. This was a violation of the SRA. We found another sales agent providing free office space to two adjusters who also verified his personal crop losses. He received indemnities of over $350,000. We have an ongoing criminal investigation of this situation. This agent's book of business totaled 350 policies, and only four of those 350 policies did not receive an indemnity for 1997. We also found sales agents who were employed by the producers to whom they sold policies. In one case, during 1995 and 1996 the agent received $284,000 in commissions from his employer's policy, along with $120,000 in salary, and the producer/employer received about $2.4 million in indemnities. Neither the reinsured company nor its attorney considered this last situation to be a conflict of interest.

Loss Adjusters' History Of Errors

Loss adjustment is a critical step in loss claims processing. It determines the amount of indemnity a farmer will receive. We identified questionable indemnities caused by improper loss adjustments in a number of recent audits. For example, we found loss adjusters did not properly establish the insureds' actual production in loss years which resulted in inflated indemnity payments. In a nursery claim, the adjuster didn't even verify a grower's claim that a tornado caused his loss and authorized a $243,000 indemnity payment. We subsequently determined that the claim was false. In a summary report of 11 audit and 17 investigation reports, we determined that RMA needed to improve its reviews of large loss claims. We found questionable indemnities totaling about $980,000 of the $11 million reviewed. Our audits and investigations consistently find this type of weakness in the loss adjustment process.

Policies Need To Be Properly Researched And Developed

RMA needs to better research and review crop insurance policies before those policies go into effect. Flawed policies increase moral hazard risks. Policies that encourage program abuse by producers are said to create a moral hazard risk. RMA issued flawed policies for three crops, pima cotton, popcorn, and corn, in three respective separate areas in Texas. The insurance provided non irrigated coverage when, in the insured areas, the crops could realistically only be grown with irrigation. However, it was known from the outset that the crops were to be grown on non-irrigated land. RMA's own field personnel advised them not to issue these policies, but RMA issued them anyway. RMA also established related yields and rates that were significantly higher than could realistically be expected. Producers subsequently obtained policies to "farm the insurance program" rather than plant with realistic expectations of bringing the crop to harvest. RMA paid indemnities of over $20 million for losses associated with this coverage. In another case, RMA has overestimated the durum wheat premium on its Crop Revenue Coverage (CRC) by 77 cents per bushel. Potentially, the excessive cost to RMA for this error could be as high as $74 million.

Optional Units

RMA's optional unit process also increases moral hazard risk. Under RMA's optional unit procedures, farmers are allowed to define their acres of production in separate units. However, we found that these procedures may be resulting in higher costs to the Government. In our statistical review of policies for crop year 1991, we pointed out that the net costs to the Government could have been reduced by as much as $336.7 million if the units per producer had been limited to one per county or basic units. These cost savings would be realized in both administrative expenses incurred by the reinsured companies and in indemnity payments. In this review and in other audits, we found that some farmers were not often able to substantiate from which unit the production was harvested or that units which were contiguous often had disparate yields or production. The optional unit policy may have allowed some farmers to manipulate their losses by shifting production from one unit to another, creating losses on some of their units. In our review of the 1994 raisin crop year, we found that, for a sample of 14 farmers, the number of units and expected production increased in loss years compared to non-loss years.

RMA Needs To Provide Better Guidance To RMA Regions And Companies

RMA has not provided adequate guidance to program officials and reinsured companies to adequately administer the program. RMA's existing program handbooks are obsolete. RMA's regional service offices did not receive guidance to ensure that premiums were properly established. RMA did not take an active role in monitoring the transfer and servicing of CAT Program policies from the Farm Service Administration to the reinsured companies. The agency did not require the reinsured companies to advise limited resource producers about available fee waivers or otherwise provide guidance for handling the special servicing needs of these farmers.

We also found that RMA had not informed reinsured companies about the limitations of its nonstandard classification system. This system was supposed to flag growers with excessive loss histories for special premium rate calculations. During our review of nursery policies, we found a grower who had hired a former FCIC official as a consultant, and circumvented this system by using different names each year. This grower had received almost $3.8 million in indemnities during the period 1993 through 1997. The consultant received 3 percent of the indemnity amounts for her services. Had the system been effective, the producer's premiums would have increased from about $82,000 to $1.9 million and from $91,000 to $1.3 million for 1997 and 1998, respectively. The producer continues today to be able to purchase insurance at normal rates.

RMA Relied Too Heavily On Reinsured Company Quality Control Reviews

The reinsured companies are responsible for providing oversight of the crop insurance program to assure that the program is being administered in accordance with SRA and USDA-approved policies. We have repeatedly reported deficiencies in the quality control (QC) functions reinsured companies use to meet this obligation. Specifically, reinsureds' QC systems were not used effectively as controls to help improve program delivery, ensure program integrity, and report on program performance. The QC reviews were superficial and were performed by people who lacked independence. In one of our audits, we reviewed the largest loss claims of $100,000 or more in each region of the country, a total of 35, and questioned 17. Reinsured companies performed QC reviews on all of these policies, but did not identify any of the deficiencies identified by OIG. This breakdown of the reinsureds' QC process was confirmed by RMA's own compliance staff who, in 1997, conducted 15 operational reviews and found 11 reinsureds had QC deficiencies.

We have also recommended improvements in RMA's compliance staff operations. In a recent review, we reported that the agency could enhance the function of its Risk Compliance Staff by (1) more effective use of its review results, (2) grater involvement and accountability of other RMA divisions, (3) initiating a system to analyze review results to determine trends and areas vulnerable to abuse, and (4) a more effective system to track program abuse complaints and corrective actions taken by the responsible RMA division.

In the final analysis, Mr. Chairman, we welcome this debate and look forward to working with all interested parties to assure that we have a crop insurance program that serves as a safety net and protects our nation's farmers. This concludes my prepared statement
Mr. Chairman. I will be happy to answer any questions you may have.

GOVERNMENT COSTS VS. REINSURED COMPANY GAINS/LOSSES 1981-1998

(Millions of Dollars)

Year	Net Costs to the Government	Underwriting Gains/Losses	Loss Ratio
1981	$ 182.5	$ 0.3	1.08
1982	355.3	2.6	1.34
1983	480.1	(2.4)	2.03
1984	475.6	(0.4)	1.47
1985	546.0	3.4	1.55
1986	524.6	8.0	1.62
1987	281.7	16.7	1.01
1988	956.5	(8.0)	2.44
1989	982.1	28.1	1.49
1990	750.4	52.2	1.16
1991	773.3	42.0	1.29
1992	708.8	22.6	1.21
1993	1,367.5	(82.5)	2.19
1994	377.1	104.4	0.63
1995	1,516.9	130.9	1.02
1996	1,447.7	245.8	0.83
1997	989.0	360.2	0.56
1998	1,507.7	335.8	0.85
TOTALS	$14,222.8	$1,259.7	1.13

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Chart 1

CATASTROPHIC RISK PROTECTION

(As Provided by Reinsured Companies)

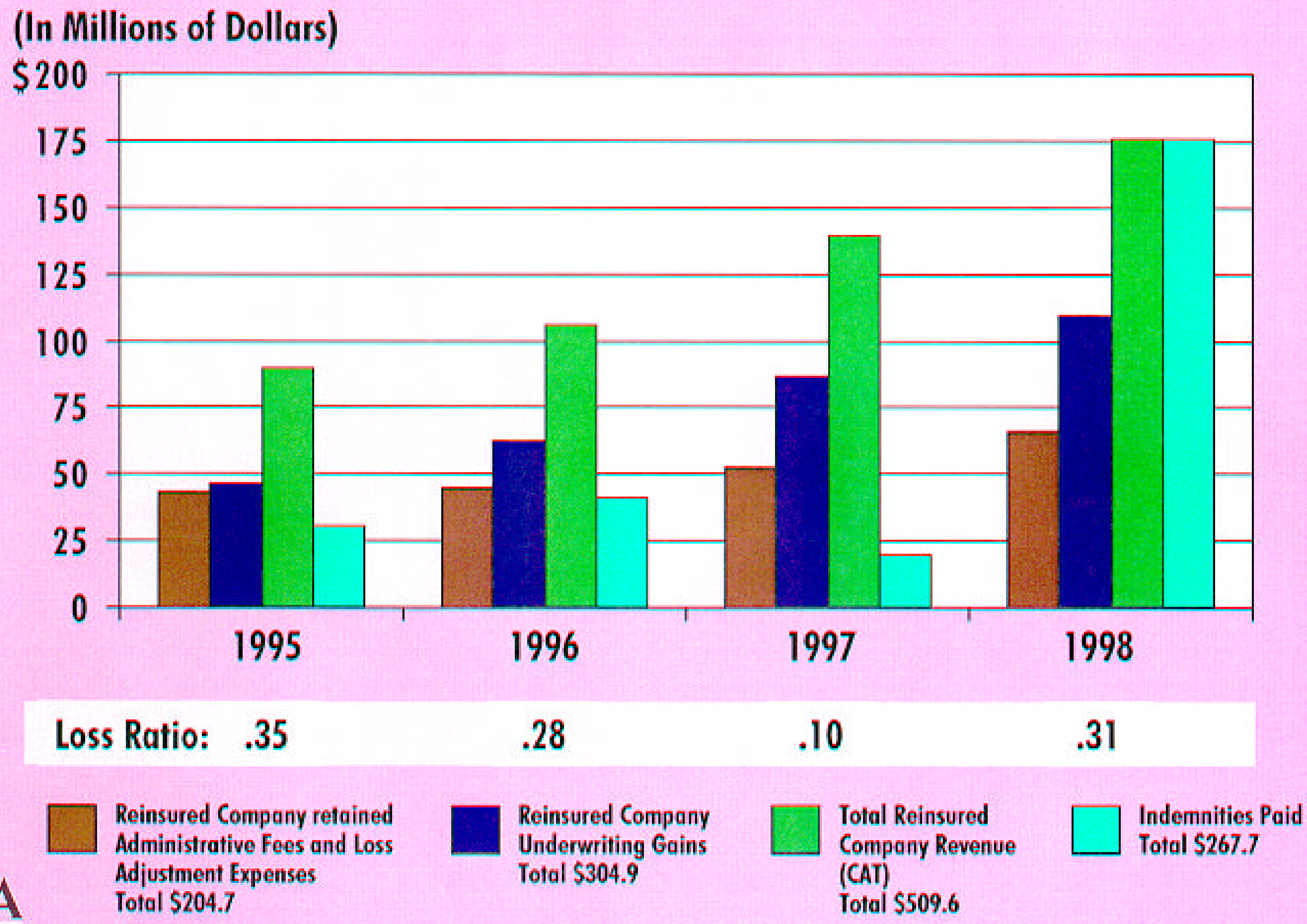

Chart 2

INDEMNITIES PAID VS. REINSURED COMPANY GAINS/LOSSES 1981-1998

(Millions of Dollars)

Year	Total Indemnities Paid	Net Indemnities (Losses) Paid[1]	Reinsured Company Gains	Reinsured Company Loss	Loss Ratio
1981	$ 407.3	$ 77.5	$ 0.3	$	1.08
1982	527.1	224.2	2.6		1.34
1983	584.8	360.8		-2.4	2.03
1984	639.3	302.0		-0.4	1.47
1985	683.8	343.2	3.4		1.55
1986	615.9	323.1	8.0		1.62
1987	370.1	91.3	16.7		1.01
1988	1068.9	739.2		-8.0	2.44
1989	1224.1	609.5	28.1		1.49
1990	972.0	349.2	52.2		1.16
1991	954.8	406.7	42.0		1.29
1992	918.2	355.0	22.6		1.21
1993	1655.4	1098.3		-82.5	2.19
1994	600.9	-94.6	104.4		0.63
1995	1574.5	919.3	130.9		1.02
1996	1520.6	661.9	245.8		0.83
1997	992.1	117.5	360.2		0.56
1998	1607.9	674.4	335.8		0.85
TOTALS	$16,917.7	$7558.5	$1,353.0	$93.3	1.13

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1) Net of Producer Paid Premiums

Chart 3

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